NO. [redacted] 268

IN THE

Supreme Court of the United States

OCTOBER TERM, 1938

F. H. E. OIL COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE.

Petition for a Writ of Certiorari to The United States Circuit Court of Appeals for the Fifth Circuit

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The F. H. E. Oil Company prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the case of Commissioner of Internal Revenue v. F. H. E. Oil Company, No. 8800 on the docket of said Court, on March 21, 1939, reversing a decision of the Board of Tax Appeals.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 34-42) was not reported. The opinion

of the Circuit Court of Appeals (R. 63-68) is not yet officially reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 21, 1939. (R. 69). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The Petitioner is entitled to deduct allowances for the depletion of oil properties in computing its taxable income for the fiscal year ended January 31, 1932, under Sec. 104(b)(3) of the Revenue Act of 1932, fixing this allowance at "27½ per centum of the gross income from the property" but not more than "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property."

The question presented is whether in computing this fifty per centum limitation, intangible drilling and development costs currently incurred with respect to any property, and currently deducted in computing taxable income because of an irrevocable election so to do made by the taxpayer in 1925, are to be deducted from "gross income from the property" along with operating expenses, admittedly deductible; or whether the limitation should be based, as to each property, upon operating profit.

STATUTES INVOLVED

Revenue Act of 1932:

"Sec. 23. *Deductions from Gross Income.* In computing net income there shall be allowed as deductions: * * *

(l) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * *

Sec. 114. *Basis for Depreciation and Depletion.*

* * * *

(b) *Basis for depletion.*—

* * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it

would be if computed without reference to this paragraph."

STATEMENT

The Petitioner is a Texas corporation, organized in 1925, engaged in the business of producing oil (R. 35). In determining its income tax liability for the fiscal year ended January 31, 1932, the Petitioner calculated its depletion allowances, where said allowances were to be determined under Section 114(b)(3) of the Revenue Act of 1932—"percentage depletion"—,by deducting from its gross receipts from oil produced from each property the operating charges with respect thereto,—that is, direct operating expense, depreciation on equipment used in producing, taxes upon the property and a ratable portion of the overhead expense. If 50 per cent of the remainder thus obtained was less than 27½ per centum of the gross receipts, Petitioner took the smaller sum as the depletion allowable on that property. In calculating this limitation, it did not deduct from gross revenue any intangible drilling and development costs which it might have incurred in that year in developing, as distinguished from operating, that property. This method of calculation was approved by the Board of Tax Appeals (R. 40-41).

The Petitioner had, in 1925, in accordance with the option granted to oil operators,[1] upon condition

[1]Art. 223, Reg. 69 (1926 Act). It had been the practice to grant this option under similar conditions since 1918. See Art. 223, Reg. 45 (1918 Act); T. D. 4333, C. B. XI-1-p. 31.

that they consistently follow the practice, elected to charge off and deduct, in computing its taxable income, the intangible drilling and development costs currently incurred by it in each tax period. (R. 55). It followed this practice in the fiscal year ended January 31, 1932, but did not take these costs into consideration in calculating the limitation on depletion allowable.

"Intangible drilling and development costs" are defined by Regulations[2] in the following language:

> "All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas * * *. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road-making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas."

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[2]Art. 223, Reg. 69 (1926 Act); Art. 236, Reg. 77 (1932 Act). T. D. 4333 C. B. XI-1-p. 31.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the limitation on Petitioner's depletion allowance, under Section 114(b)(3) of the Revenue Act of 1932, should be computed by taking into consideration the intangible drilling and development costs currently incurred with respect to a property and, because of its irrevocable election so to do made long prior to the tax year, deducted in computing its taxable income.

2. In failing to hold that such intangible drilling and development costs should not be deducted from Petitioner's "gross income from the property" in computing "the net income of the taxpayer (computed without allowance for depletion) from the property" under Section 114(b)(3) of the Revenue Act of 1932.

3. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals in this case conflicts with the decisions of the Circuit Court of Appeals for the Ninth Circuit in *Helvering v. Wilshire Oil Company, Inc.*, 95 Fed. (2d) 971, and *Ambassador Petroleum Company v. Commissioner*, 81 Fed. (2d) 474. The *Wilshire Oil Company* case involved the tax years 1929 and 1930, and identical language in Sec. 114(b)(3) of the Revenue

Act of 1928. The Ninth Circuit Court held that the intangible drilling and development costs which that Company had incurred in the years involved under the same circumstances present in the case at bar should not be taken into consideration in computing the limitation upon allowable percentage depletion. In so doing it followed its prior decision in *Ambassador Petroleum Company v. Commissioner*, 81 Fed. (2d) 474, which involved identical facts and arose under identical statutory language contained in *Section 204(c)(2)* of the Revenue Act of 1926. The Commissioner of Internal Revenue applied for Certiorari in the *Wilshire Oil Company, Inc.* case (No. 163 on the docket of this Court) on June 30, 1938, asserting that there was involved "an important question of Federal Tax Law which has not been, but which should be settled by this Court." This petition has not been acted upon.

The Fifth Circuit Court of Appeals expressly recognized that its decision conflicted with these two decisions by stating:

> "The decision in *Ambassador Petroleum Co. v. Commissioner*, supra, deals with the 1926 Act. It reversed the Board and has been consistently followed by the Board ever since. The Court considered the rule of legislative approval urged by the Commissioner and turned it against him. Based upon the history of the law and Treasury rulings, the Court concluded, for the purpose of computing depletion, net income and operating profit are synonymous and held that develop-

ment costs deducted as expense should be excluded in computing net income. The case of *Commissioner v. Wilshire Oil Co., Inc.*, supra, dealing with the Revenue Act of 1928, follows the same line of reasoning. We do not find these decisions persuasive." (R. 66).

2. The Circuit Court of Appeals, in the holding above referred to, has erroneously decided an important question of Federal Tax Law, which has not been, but should be settled by this Court. To support this, the statements as to the importance of the question contained in the Commissioner's Petition for Certiorari in the *Wilshire Oil Company, Inc.* case, supra, are adopted.

3. In holding that the Commissioner of Internal Revenue could completely reverse his interpretation of identical language in earlier Acts limiting allowable depletion, even though this interpretation had been reported to Congress, and approved through the continued use of the language in later taxing acts, and in failing to give controlling weight to this Congressional approval of departmental construction, the Circuit Court of Appeals for the Fifth Circuit rendered a decision conflicting with decisions of this Court and many Circuit Courts of Appeals.

In Sections 214(a)(10) and 234(a)(9) of the Revenue Act of 1921, Congress provided that the allowance for depletion based upon discovery value should be limited to the "net income, computed without allowance for depletion, from the property upon

which the discovery is made." The Bureau of Internal Revenue thus construed this language:

> "Net income is the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less *operating expenses*,[3] including depreciation on equipment, and taxes, but excluding any allowance for depletion." Art. 201(h) Regulations 62.[4]

When the Revenue Act of 1924 was before Congress, the Treasury Department recommended that this limitation be reduced. Its representative stated to Congress:

> "The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The proposed draft limits discovery depletion to 50 per cent of the *operating profit* (from the property) upon which the discovery has been made."[5]

Congress adopted this recommendation by providing in Section 204(c) of the Revenue Act of 1924:

> "But such depletion allowance based on dis-

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[3]In Art. 223 of these Regulations 62, intangible drilling and development costs were classified as a "development expense", not as an operating expense.

[4]All italics throughout are supplied, unless otherwise noted.

[5]From "Statement of the changes made in the Revenue Act of 1921 by the Treasury Draft (of the 1924 Act) and the reasons therefor." See **Ambassador Petroleum Company v. Commissioner, 81 Fed. (2d) 474-6.**

covery value shall not exceed 50 per centum of the net income (computed without allowance for depletion) from the property upon which the discovery was made."

In the Senate Finance Committee Report thereon, it was stated:

"The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The bill limits discovery depletion to 50 percent of the *operating profit* from the property upon which the discovery has been made."[6]

In adopting the Revenue Act of 1926, Congress, in order to avoid administrative difficulties (See *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 318), substituted percentage depletion for discovery depletion, but both the Report of the Finance Committee and that of the Conference Committee stated:

"The provision of existing law limiting this amount to an amount not in excess of 50 percent of the net income of the taxpayer from the property is retained."[7]

The Bureau of Internal Revenue has recognized that from 1921 until the later part of 1927, it applied this limitation provision in accordance with the

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[6]Report No. 398, p. 20 (Senate Finance Committee, 68th Congress, First Session).

[7]Abstracted from Seidman's Legislative History of Federal Income Tax Laws, p. 584.

practice followed by Petitioner in the present case,[8] and that there was no *official*[9] change in position until the Regulations were promulgated under the Revenue Act of 1928, when it was provided that in computing the depletion limitation there should be deducted from taxpayer's gross income from the property "development expenses (if the taxpayer has elected to deduct development expenses)".[10]

Perhaps the holding of the Court below upon this phase of the matter, we say with respect, was occasioned because it misunderstood prior Revenue Laws and Departmental practices. It referred to the Revenue Acts of 1918, 1921, and 1924, as if they allowed depletion upon a cost basis only, saying:

> "The Revenue Acts of 1918 to 1921, inclusive, contained provisions allowing deduction of a reasonable allowance for depletion of oil and gas wells, based on *cost*, including cost of development, not otherwise deducted. The Revenue Act of 1924 continued this allowance for depletion *on the cost basis*, with the limitation that the deduction should not exceed 50% of the net income from the property, computed without allowance for depletion" (R. 66).

The opinion thus overlooks that the limitation was

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[8]G. C. M. 2315, C. B. VI-2, p. 21.

[9]The opinion expressed in G. C. M. 2315, C. B. VI-2, p. 21 as to how the 1926 Act was to to be applied was not authoritative, and, in the Bulletin in which it was published, taxpayers were warned not to rely upon such rulings. See **Helvering v. N. Y. Trust Company**, 292 U. S. 455-468.

[10]Reg. 74, Art. 221-(i) promulgated January 3, 1929.

upon depletion based on discovery value (there never having been in any Revenue Act since 1918 a limitation as to depletion based upon cost); that the 1921 Act was the first Act to contain this limitation; that the 1921 Act was construed and applied by the Treasury in accordance with Petitioner's present contention; that this construction was called to the attention of, and adopted and approved by Congress in passing the Revenue Acts of 1924 and 1926 containing identical language, and again in 1928 and 1932, when identical language was incorporated in the Revenue Acts of 1928 and 1932 without Congressional comment. Based upon this entire misconception, the Court below held:

> "Under the *1924 Act* the Commissioner had ruled that net income meant net operating revenue and excluded development costs in computing it. For awhile this practice was continued under the 1926 Act but was changed on September 26, 1927, and the present practice adopted. * * * His decisions under the previous acts were certainly not approved by the enactment of the 1926 statute. Nor do we think the short time he applied the old rule under the 1926 Act estopped him from changing it, if convinced he was wrong." (R. 67).

Thus the Court below failed to consider and give proper effect to the vital factors of construction and practice under the 1921 Act, and the approval thereof in adopting the 1924, 1926, 1928 and 1932 Acts; which should, under the decisions cited below, control.

This Court, and many Circuit Courts of Appeals, have held that when the taxing authorities have construed language in a Taxing Act, and that construction is reported to Congress and, thereafter, the same language is used in a re-enactment of the law, the departmental construction is approved and incorporated into the statutory language.. As one Court has expressed it: An interpretation thus approved became "embedded in the Statute so deep that only legislation could dislodge it." *E. R. Squibb v. Helvering*, 98 Fed. (2d) 69-70 (2nd C. C. A.). This Court has many times given controlling effect to departmental construction subsequently approved by congressional re-enactment of the language thus construed. *Brewster v. Gage*, 280 U. S. 327, 337; *National Lead Company v. U. S.*, 252 U. S. 140, 146; *Poe v. Seaborn*, 282 U. S. 101.

CONCLUSION

Wherefore, it is respectfully submitted that this Petition for Writ of Certiorari, should be granted.

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